

**Commission on Strategic Development  
Committee on Economic Development and  
Economic Cooperation with the Mainland**

**Hong Kong economy's overview  
Recent performance and near-term outlook**

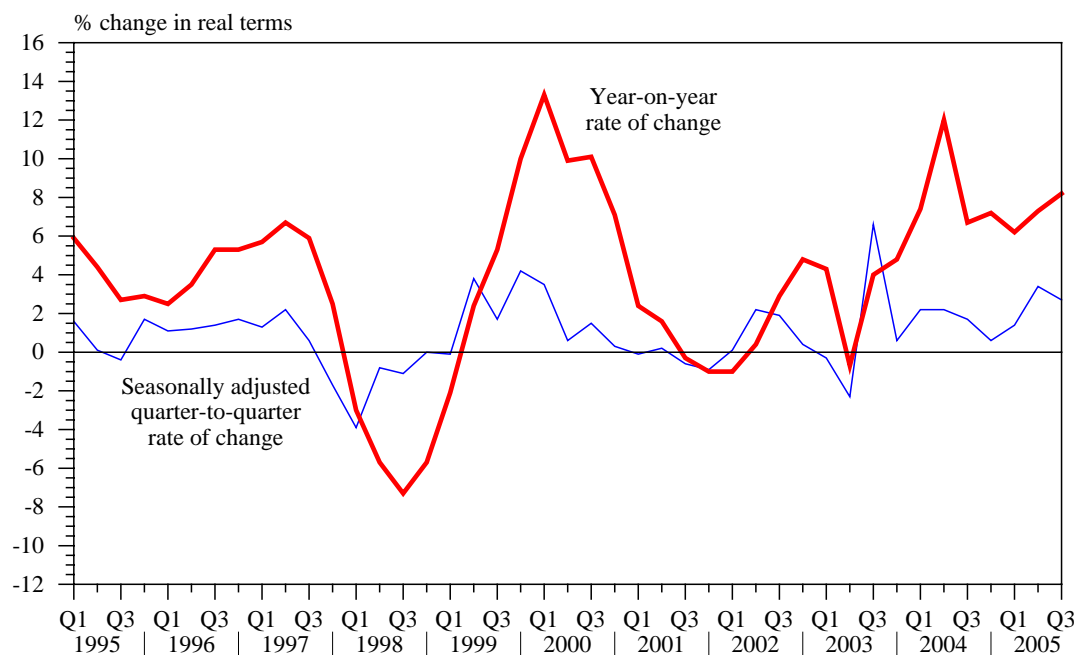
**Introduction**

This paper analyses recent developments in the Hong Kong economy and discusses the near-term economic outlook for the rest of 2005 and 2006.

**Recent economic situation**

2. The Hong Kong economy turned out an even more spectacular performance in the third quarter of 2005. While the external sector remained highly robust, consumer demand re-accelerated to a solid growth and investment demand rose further. With both the external and domestic fronts exceeding expectations, the *Gross Domestic Product (GDP)* leaped by 8.2% in real terms in the third quarter over a year earlier. This was not only up from the 6.7% growth in the first half of 2005, it also marked the eighth consecutive quarter that the economy has attained above-trend growth. On a seasonally adjusted quarter-to-quarter comparison, GDP also expanded notably further, for the ninth straight quarter, by 2.7% in real terms in the third quarter of 2005. (*Chart 1*).

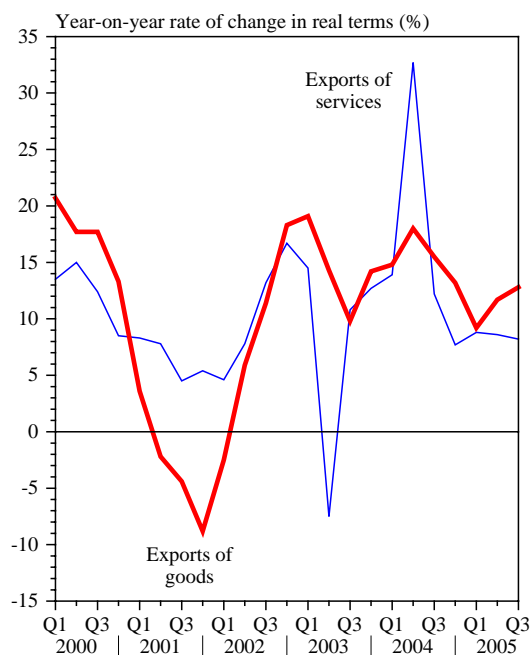
**Chart 1 : Gross Domestic Product**



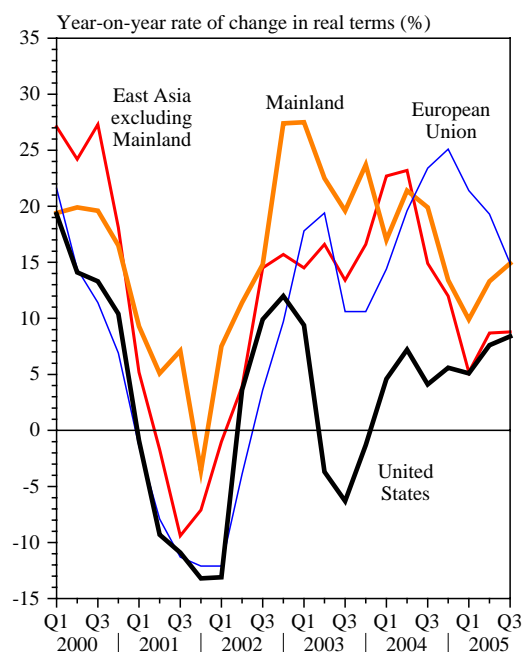
3. While the economic expansion had become more broad-based in the third quarter, the external sector with its robust performance was still the dominant driving force. *Total exports of goods* continued to grow significantly, by 12.8% year-on-year in real terms in the third quarter, reflecting the fairly strong performance of the major overseas markets as well as the Mainland's buoyant trade flows, and also the strength of Hong Kong as the trade conduit for the Mainland economy (**Chart 2(a)**).

4. Exports to all major markets recorded notable growth in the third quarter of 2005. Exports to the Mainland continued to record double-digit growth. The stellar performance was underscored by the Mainland's strong trade flows as well as its robust domestic demand. Exports to the EU were also strong, mainly reflecting the increasing penetration of Mainland's products into this market. Exports to the US maintained solid growth amidst the still firm domestic demand there. Export performance to other major East Asian markets, such as Japan, Taiwan, South Korea and Malaysia, also fared strongly, offsetting the slackening in the Singapore market (**Chart 2(b)**).

**Chart 2(a) : Total exports of goods and exports of services**

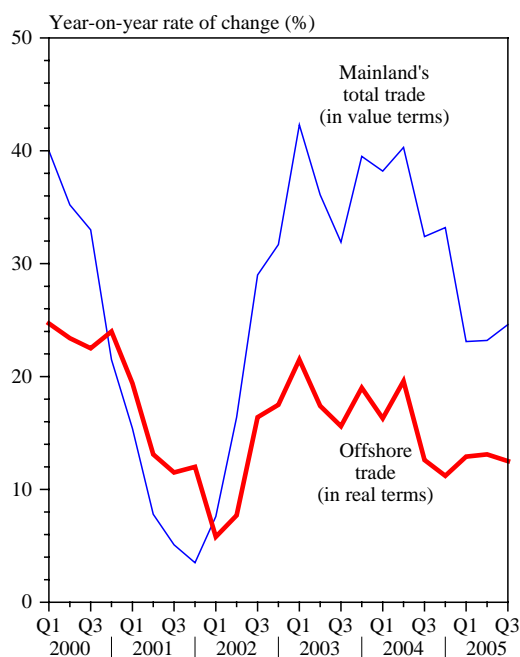


**Chart 2(b) : Hong Kong's total exports of goods by major market**

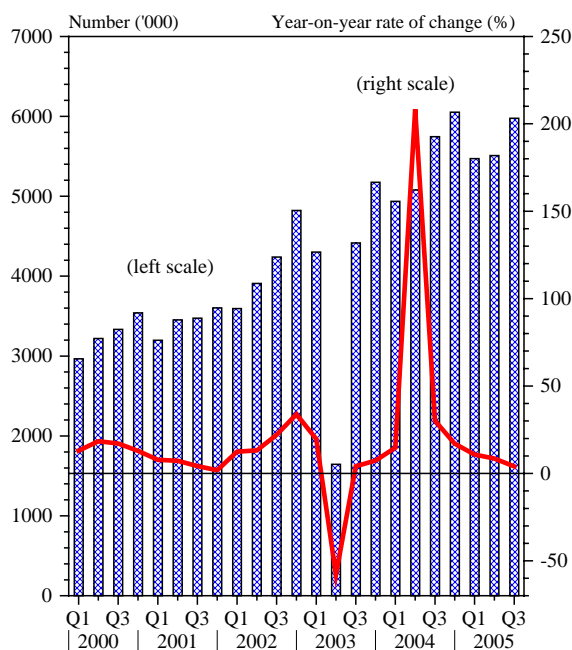


5. On invisible trade, *exports of services* expanded noticeably further, by 8.2% in real terms in the third quarter, following increases of 8.8% and 8.6% in the first and second quarters respectively. Offshore trade and exports of transportation services surged further, mainly benefited by buoyant trade flows involving the Mainland (**Chart 3(a)**). The further growth in inbound tourism provided additional support, although the momentum was not as fast as in the past few quarters. But this has to be seen in conjunction with the very rapid growth in inbound tourism over the past year or so. Also, there was possibly some postponement of leisure trips by Mainland visitors to match the opening of the new Disney theme park in mid-September (**Chart 3(b)**). In addition, the continued upturn in business activities also gave a boost to exports of finance, business and other services.

**Chart 3(a) : Offshore trade and Mainland's trade**



**Chart 3(b) : Visitor arrivals**



6. A distinct feature in the current economic recovery is the sustained strong growth in our external trade, both in goods and services. Our strong trade performance, and along with it, the massive size of our current account surplus, is a clear manifestation of the strength of Hong Kong's competitiveness as a trading and logistics hub in the region. There is often a misguided view that the rapid development of port facilities in the Pearl River Delta region (PRD) impedes competitiveness of Hong Kong's port, largely based on the observation that port cargo movements are increasingly diverted from Hong Kong to other ports in the region. Yet from a wider perspective, more efficient port facilities in the PRD are indeed beneficial to the Hong Kong economy on many aspects. A direct way by which Hong Kong benefits is through the impetus to offshore trade, an increasingly popular trading mode around the world spurred by globalisation and advancement in supply chain management. Availability of efficient port facilities in PRD actually enables Hong Kong traders and manufacturers to enjoy greater flexibility in arranging cargo freight offshore for time and cost savings. Meanwhile, their operation bases in Hong Kong can focus more on higher value-added activities such as merchanting, marketing, and logistics management. This restructuring process has contributed to the persistently robust performance of the trading and logistics sector in Hong Kong (*Table 1*). It is noteworthy that the share of the logistic sector in the Hong Kong economy has actually risen steadily through the years. This is particularly so for the air freight industry, which has benefitted substantially from the rising proportion of high-value and time-sensitive items

in Mainland's external trade. Thanks to enhanced competitiveness of the entire PRD region, the share of the trading sector in Hong Kong's GDP has risen even more markedly.

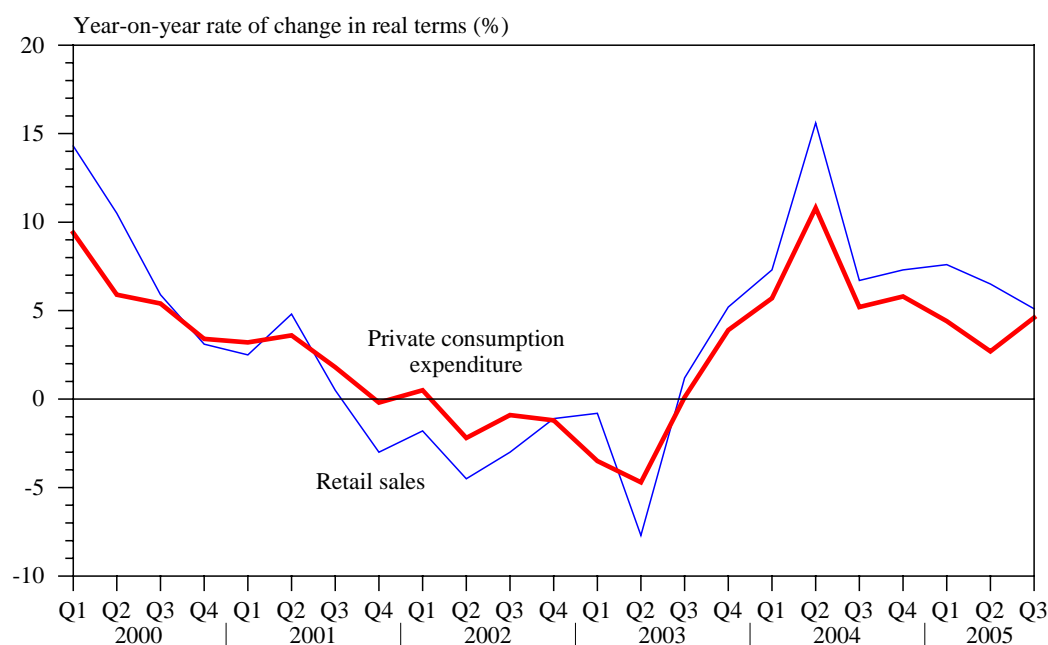
**Table 1 : Rising share of trading and logistics sector in GDP**

	<u>Trading</u>	<u>Freight transport and storage services</u>				<u>Trading and logistics combined</u>
		<u>Land</u>	<u>Water</u>	<u>Air</u>	<u>Total</u>	
1999	18.3	0.5	1.9	1.2	3.8	22.5
2000	19.4	0.5	2.0	1.3	4.0	23.8
2001	20.0	0.5	2.0	1.3	3.9	24.3
2002	20.5	0.4	2.0	1.5	4.1	25.0
2003	21.5	0.5	2.3	1.5	4.5	26.3
2004*	22.0	0.5	2.5	1.8	5.0	27.4

Note : (\*) Figures for 2004 are crude estimates

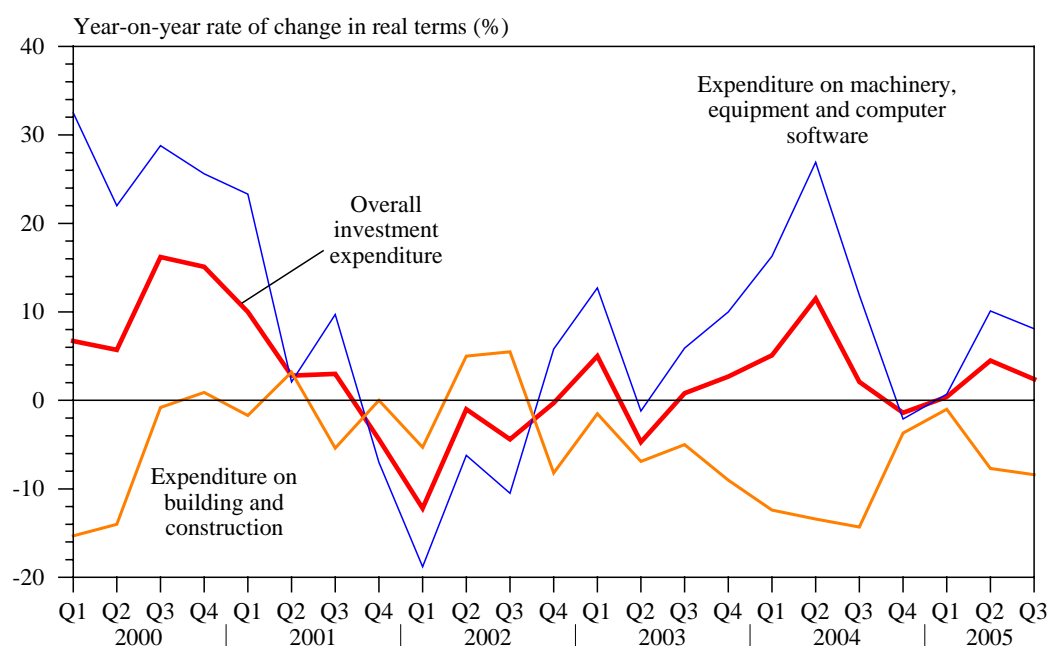
7. Another distinct feature in the current economic recovery is a more balanced growth pattern, with impetus to growth coming from both the external and domestic sectors. In the third quarter, amidst improving employment incomes and generally upbeat sentiment, *private consumption expenditure (PCE)* re-accelerated to grow at 4.6% in real terms in the third quarter over a year earlier, distinctly up from the 3.5% growth in the first half (**Chart 4**).

**Chart 4 : Private consumption expenditure and retail sales**



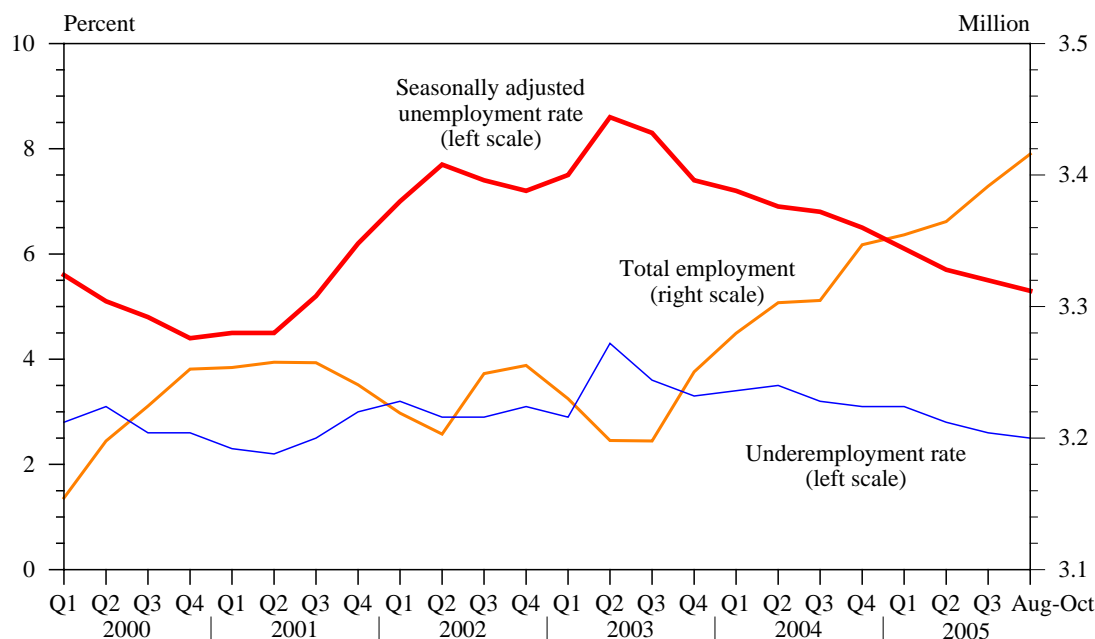
8. Overall investment spending in terms of *gross domestic fixed capital formation* also grew further, though only modestly by 2.4% in real terms in the third quarter over a year earlier, after a 2.5% growth in the first half of the year. Business sentiment remained generally upbeat, against the background of the brisk pace of economic expansion. This, together with the need to expand capacity to cope with the increased business volume, led to a further visible increase in investment in machinery, equipment and computer software in the third quarter (up by 8.1%). However, the weak building and construction activity continued to hold back the pace of upturn in overall investment. Expenditure on building and construction fell off further in the third quarter, by 8.4%, as there were still relatively few large-scale building and infrastructure projects in progress (*Chart 5*).

**Chart 5 : Investment expenditure by major component**



9. A third salient feature in the current recovery is that it has readily translated into a broad-based improvement in the labour market. By August - October 2005, the *seasonally adjusted unemployment rate* has fallen back to 5.3%, the lowest since July - September 2001 (**Chart 6**). *Total employment* rose to another new high of 3.42 million, and new jobs were created at all levels of the occupational hierarchy and across different service sectors. Fresh graduates and school leavers had been absorbed into employment at a more rapid pace than in the past couple of years. The total number of job vacancies in the private sector continued to surge in June 2005 over a year ago, and labour incomes also rose further, with payroll per person engaged in the private sector establishments rising by 3.6% in money terms in the first half of 2005 over a year earlier.

**Chart 6 : Unemployment and underemployment rates and total employment**

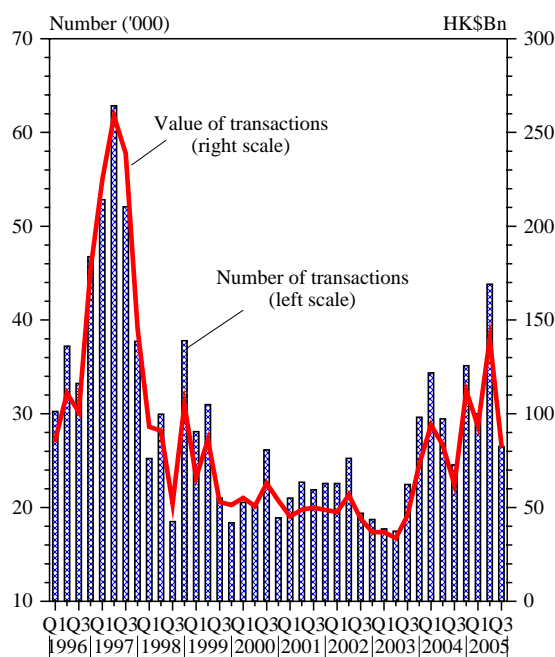


10. The improvements in the labour market over the past two years have indeed been remarkable. Some 220 000 additional jobs had been created during the current economic recovery, benefiting both higher and lower skilled workers across different sectors. The number of long-term unemployed persons also came down markedly, from the peak of 93 000 in 2003 to about 59 000 in the three-month period August-October 2005. Many of these unemployed workers who managed to secure a job over the past few quarters are those with lower educational attainment or belong to the lower-skilled category. They once again re-affirm the remarkable flexibility and adaptability of Hong Kong's labour market in response to external shocks and the challenges emanating from the ongoing restructuring of the economy. These positive developments indicate that even the hard core of the unemployed are able to benefit from economic revival once the recovery can broaden to a full-fledged upturn, even though the pace of improvement may vary amongst different skill categories. Admittedly, people who are aged over 50, with lower education and of lower skill level are prone to higher unemployment than those equipped with higher education and of higher skill level. But in general, the quality of the workforce had been improving over the years, as can be seen by the growing size of professional, managerial and technical workers in our workforce, and also the significant improvement in labour productivity. The huge investment in education and human development over the past years has helped lay a strong foundation for Hong Kong developing into a competitive knowledge-based economy.

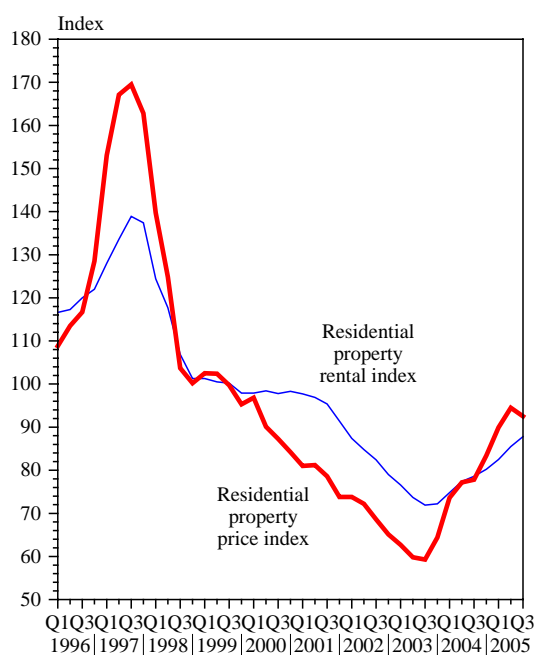


11. As to the asset market developments, the property market as a whole turned quieter in recent months, representing a consolidation from the hectic situation earlier this year. Overall property prices met with moderation pressure, though the adjustment was mild as the longer-term market outlook stayed positive. On a quarter-to-quarter comparison, flat prices reverted to decline by 2% in the third quarter of 2005 (**Chart 7(a)**). The leasing market nevertheless improved steadily in overall terms, underpinned by progressive pick-up in end-user demand. Flat rentals moved up moderately by 3% in the third quarter (**Chart 7(b)**).

**Chart 7(a) : Number and value of property transactions**



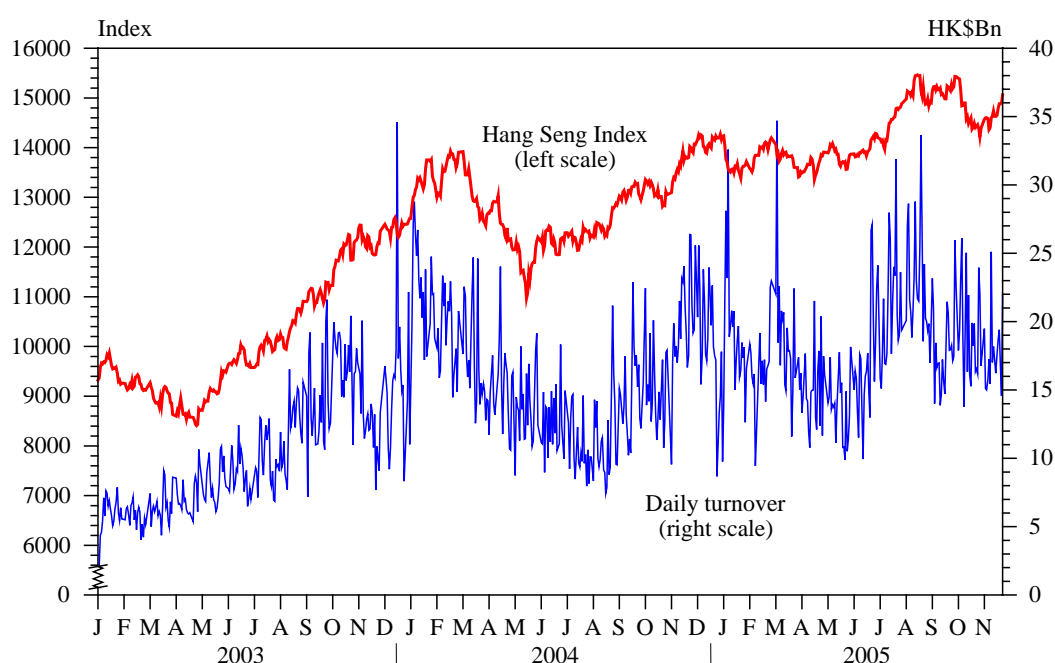
**Chart 7(b) : Prices and rentals for residential property**



12. In the financial market, local *share prices* were buoyant for most of the time in the third quarter of 2005, underpinned by progressive improvement in the local economy and good corporate earnings. The Hang Seng Index hit 15 466 on 15 August, the highest level in 2005. The index closed at 15 429 at end-September, up by 8.6% over end-June. Yet, between early October and mid-November, the Hang Seng Index dipped below 15 000, due partly to renewed concerns over an extension of up-cycle in US dollar interest rates. But lately the index moved up again to level of above 15 000. In general, the local stock market has been rather resilient on the back of an improving economy (**Chart 8**).

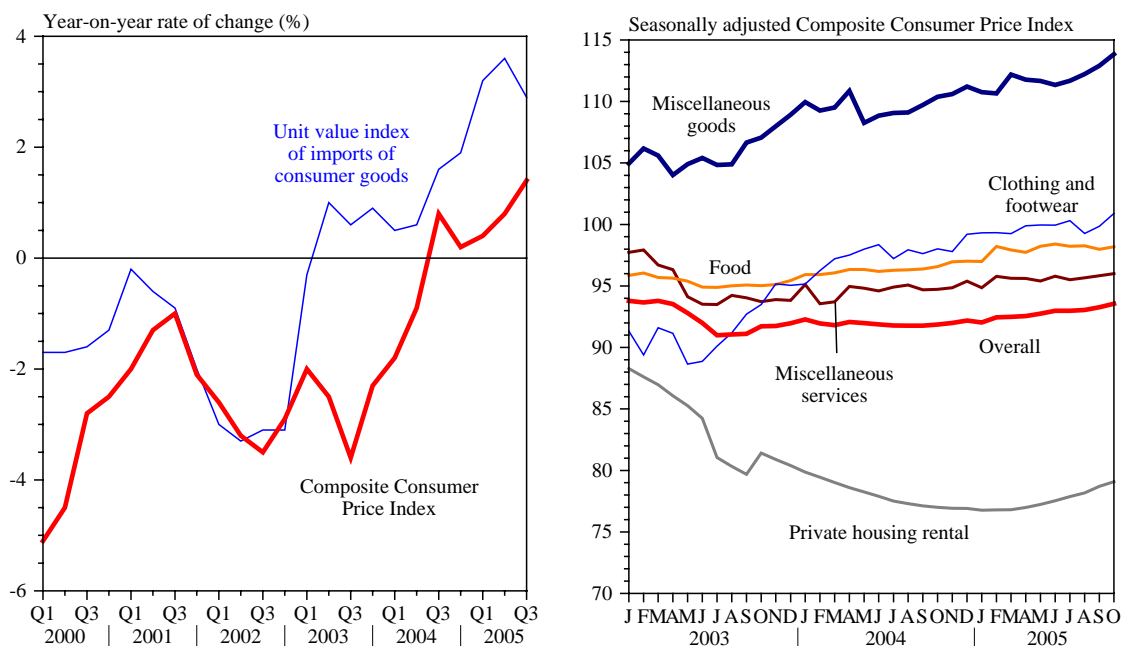
13. Mainland enterprises play an increasingly important role in the Hong Kong stock market. At end-October 2005, there were 322 Mainland enterprises listed on the Hong Kong stock market, accounting for 29% of the total number or 38% of the total market capitalisation. Meanwhile, on 1 November 2005, further measures were unveiled to expand the scope of renminbi business in Hong Kong. This would further strengthen the financial link between the Mainland and Hong Kong to mutual benefit.

**Chart 8 : Hang Seng Index and stock market turnover**



14. Consumer price inflation notched up slightly further during the third quarter, reflecting the buoyant economic upturn, progressive feed-through from the earlier rental rebound and also some modest impact from higher fuel cost. Yet on the whole, price pressures remained well contained so far, as the strengthened demand was largely matched by expansion in productive capacity coupled with continued productivity enhancement. The *Composite Consumer Price Index* rose by 1.4% in the third quarter of 2005 over a year earlier, and moderately further by 1.8% in October, giving an average increase of only 1.0% for the first ten months of 2005 as a whole (*Chart 9*).

**Chart 9 : Hong Kong's price movement**

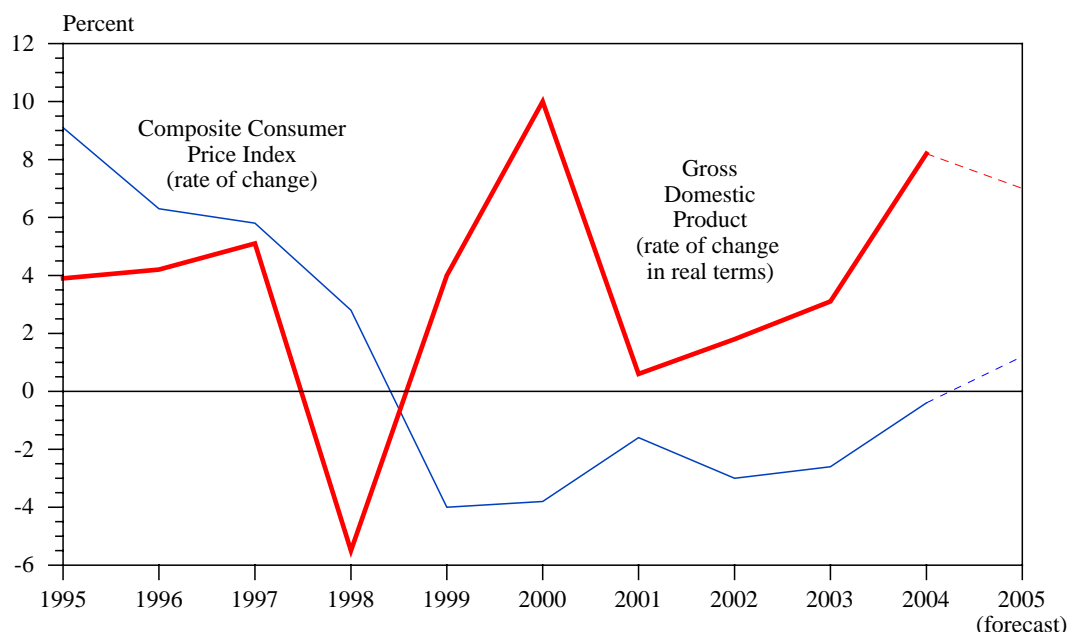


## Updated economic forecasts for 2005

15. On the back of the highly robust growth of 7.3% attained in the first three quarters of 2005, the forecast GDP growth for 2005 as a whole is raised from 4.5-5.5% to 7% in the current round of forecast update. This has given due allowance for some moderation in the global and regional demand in the fourth quarter, and has also taken into account the dent in domestic demand from successive interest rate hikes (*Chart 10*).

16. The inflation environment remains benign, as both unit labour cost and unit rental cost continue to show modest increases in recent period. Given the lower-than-expected actual outturn so far, and with the pace of rise-back in CPI inflation likely to remain gradual in the remaining months of the year, the forecast Composite CPI inflation for 2005 as a whole is revised slightly downward to 1.2% from the earlier forecast of 1.5%.

**Chart 10 : Forecast of Gross Domestic Product and Composite Consumer Price Index for 2005**



## **Economic outlook for 2006**

17. Trade outlook in 2006 is still beset with a range of uncertainties, including whether the global economy is able to sustain reasonably solid growth momentum; to what extent avian flu would impact on global economy and international trade; whether Mainland's trade can maintain strong growth as in this year; whether US dollar will continue to strengthen; by how much more the impact of the earlier oil price surge will show up in 2006, etc. In addition, in the international financial markets, there are lingering concerns about the possible corrections of the US housing market and the persistent huge US current account deficit. With the impact of the successive interest rate hikes showing up more fully in 2006, it is not unlikely, indeed natural, for economic growth to ease back in 2006, after attaining two consecutive years of very rapid growth. Much depends on how well the global economy can extend the current pace of economic expansion into 2006.

18. Against the lingering uncertainties and downside risks, however, the implementation of the three phases of CEPA, as well as the broadening and deepening of the co-operation with Guangdong and the Pan-PRD region will continue to render support to Hong Kong's economic growth. It should also

be noted that the economic fundamentals of Hong Kong have strengthened up significantly after the substantial corporate downsizing and downward adjustments in cost structure since 1998, which should enable Hong Kong to weather external shocks better than before. On this, it is thus all the crucial for Hong Kong to keep up with its ability to adapt and respond to external shocks and the challenges posed by globalisation and the on-going re-structuring. A key element in creating this capability is a flexible labour market, which enables the corporate sector, and indeed the economy as a whole, to adjust swiftly to unforeseen shocks, whether they stem from local or external fronts.

19. We will take into account the above factors when preparing the economic forecast for 2006, which will be announced along with the Budget Speech in February 2006. As a reference, the International Monetary Fund lately forecasts that the Hong Kong economy would grow by 4.5-5% in 2006, and the forecasts put out by private sector analysts are mostly in the range of 4-5%. These forecasts essentially expect GDP growth to ease back to a level which is more commensurate with the trend GDP growth in the past.

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